



# READING THE NUMBERS

BY JOHN DOLAN-HEITLINGER

**A**s a volunteer board member looking at your organization's financial statements, are you confident that you would know if your credit union is financially secure or if it is teetering on insolvency?

If you don't have an academic or occupational background with financial statements, you may not be comfortable with the expectation that you should be able to glean your credit union's financial health from a stack of papers with a bunch of numbers. But part of your commitment as a director is ensuring that your credit union employs safe and sound fiscal management. You owe it to yourself and the credit union membership to learn how to understand what is right, and what is wrong in the financial statements of your credit union.

That said, directors today should expect that the financial information presented to them should include not only the numbers, but also graphic charts which enable even the new director to easily see trends and comparisons to the competition. Quality ways in which to present financial data through graphic charts are a topic for another article.

Here we will only deal with the basic terminology, money flow, and some ratio analysis. This is a very simplified but still meaningful learning tool. My definitions of "good" and "bad" are based upon more than 23 years in the credit union industry, most of it as a CEO.

Listed below are some financial terms you will see on financial statements and hear discussed in board meetings.

## FINANCIAL TERMS

- **Assets:** loans, investments, buildings, equipment, cash—what you make money on.
- **Liabilities:** deposits, payables, capital—what you pay interest on, and previous profits. (Assets and liabilities must always equal each other, which is why the report that contains these two items is called the balance sheet.)

Your credit union financial statements tell a story. It's your job to make a commitment to understanding them.

- **Income:** what members and others paid you that month, mostly in interest and fees.
- **Expense:** what you spent that month on human resources, keeping buildings open, operating your technology.
- **Dividends:** what you paid to your members for their deposits that month.
- **Capital:** Previous profits, the money that would be left if the members took all their deposits out of the credit union.
- **Net Income:** profits, the income left over after expenses and dividends. (The last five items are the major components of the report called the income statement. They reflect an accumulation during the previous month, such as how much the credit union spent on salary expenses for the month.)
- **Delinquency:** loans that we haven't received a payment on for 60+ days.
- **Charge-offs:** loans unlikely to be fully paid back
- **Ratio:** a fraction, a performance measure.

Figure 1 (p. 26) is a model of how credit union financial statements work. We will discuss the two primary financial statements used by credit unions, the balance sheet and the income statement.

The top two (pink) blocks—assets and liabilities—make up the balance sheet. The lower (yellow) block is the income statement. We'll start with the balance sheet.

The balance sheet is a snapshot in time, typically the end of the month. You can think of it as the last line in your personal credit union statement that shows your

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end-of-month checking account balance.

If we were starting a credit union we would begin with some deposits or shares. We would either not have any capital or payables or they would be inconsequential.

We would then need to make some loans. Remember: As credit unions, we exist primarily to extend credit to our members. Any funds in the credit union from the deposits that we couldn't loan out would be held as cash or put into investments.

During the month we would make interest income from loans and investments and we would also earn some fees. This income flows (green lines) to the income statement.

The income statement figures are a tabulation of the income and expenses over the month. The income the credit union earns is then spent on expenses and paid out to its members as interest on their deposits (referred to as dividends in a credit union).

Any income left over at the end of the month not used for expenses or dividends is retained by the credit union as profit. These retained profits flow back up to the balance sheet and become capital. Capital is all the retained profits accumulated since the beginning of the credit union. If expenses exceed income, that loss is covered by using some of the capital previously built up.



That is how the financial statements work.

Now, so that we can see how the numbers interact with each other in financial statements, I have created a mythical credit union. Its data is listed in Figure 2.

At the board level these numbers should be primarily examined in two ways: first, as ratios to each other; and second, as trends over time.

**WHY USE RATIOS?**

- They are an industry standard way to measure performance.
- They can make both huge and tiny numbers meaningful.
- They are a way to compare credit unions and banks, even of very different sizes, to each other.
- The National Credit Union Administration uses ratios extensively.
- They can give you a warning of impending disaster.

Remember that ratios are fractions with both a numerator and a denominator. Changes in either the numerator or the denominator can cause the ratio to change.

The following ratios and trends provide a very good start for directors who want to improve their understanding of credit unions financials.

**Net worth ratio (net capital to assets):** primary measure of soundness and strength and the foundation for credit union growth. Your net worth ratio can act like a governor on your growth.

- Profits made over the years (capital) divided by total assets = net worth ratio.
- In our example, \$8 million in capital/\$100 million in total assets = 8 percent net worth ratio.
- Generally, a higher number is better.
- Less than 7 percent is probably too low, 8-10 percent is normal, higher than 10 percent may be higher than necessary.
- A falling number may mean the CU is losing its ability to withstand adversity.
- The board should analytically develop a target capital ratio range.

This range is likely to be different for each credit union's individual situation. Going below 7 percent will likely draw regulator attention. If you have a ratio above 10 percent you should have a very good reason why you are not returning this excess capital to your members. Maintaining too high a ratio hurts your members.

**Return on assets (ROA):** the measure of profitability. This profitability (net income) is the credit union's source of capital to maintain the net worth ratio at an appropriate level.

- Net income (annualized) divided by total assets.
- \$50,000 in net income \* 12 months/\$100 million in total assets = 0.6 percent ROA.
- Generally a higher number is better.
- Less than 0.5 percent is probably too low, 1 percent

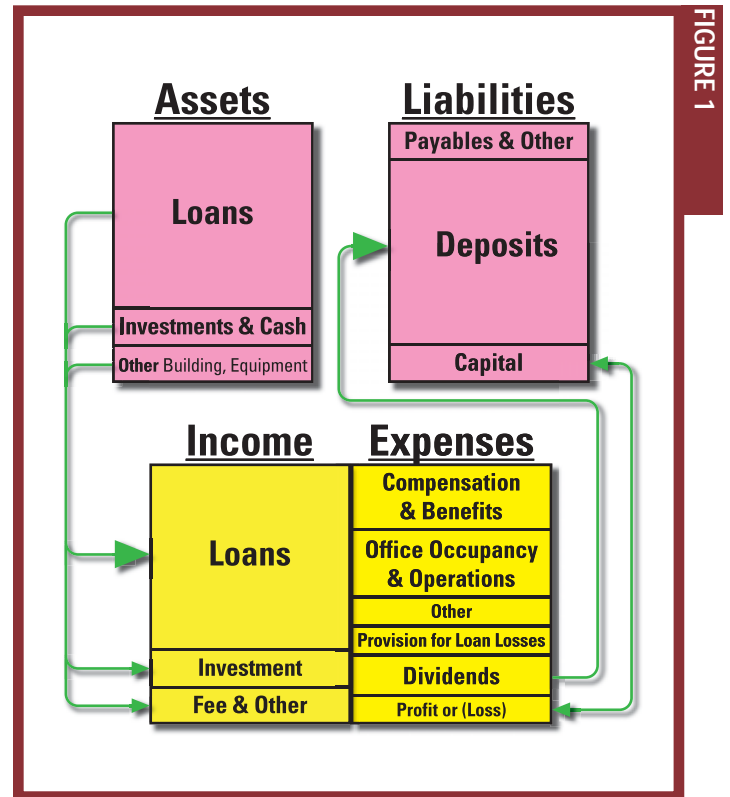


FIGURE 1

**EG CREDIT UNION**

Membership: 9,000 members;  
5,000 checking accounts

Assets:	\$100 million
Deposits:	\$92 million
Loans:	\$90 million
Capital (reserves/retained profits):	\$8 million
Allowance for Loan Losses:	\$400,000
Monthly Net Income:	\$60,000
60 Day-Plus Delinquency:	\$400,000
Monthly Charge-Offs: <small>(also provision for loan losses monthly expense)</small>	\$50,000
Monthly Operating Expenses:	\$350,000
Monthly Fee (Other) Income:	\$130,000
Net Monthly Operating Expense:	\$220,000
Monthly Interest Expense:	\$250,000
Monthly Interest Income:	\$640,000

FIGURE 2



is normal, 2 percent is extremely high.

- The board should set a target ROA number

**Delinquency ratio:** A primary measure of loan portfolio and underwriting quality. These are loans that are in danger of never paying off fully.

Loans delinquent by 60 days or more divided by the entire loan portfolio.

- \$400,000 in delinquent loans / \$90 million in loans = 0.4 percent delinquency.
- Generally a lower number is better.
- Less than 0.2 percent may reflect too conservative underwriting; 0.5 percent to 2 percent is normal; more than 2 percent may indicate a problem.
- Warning: Rapid loan growth artificially reduces this number.
- Mortgages should have very low delinquency.

The mortgage crisis that began in 2007 has caused higher than normal delinquency rates, particularly in mortgages.

**Loan charge-off ratio:** another primary measure of loan portfolio and underwriting quality. These are loans that are unlikely to ever be paid off.

- Monthly charge-offs (annualized) divided by the entire loan portfolio.
- \$50,000 in loans charged off \* 12 months / \$90 million in loans = 0.7 percent charge-off rate.
- Generally a lower number is better.
- Less than 0.1 percent may reflect too conservative underwriting; 0.3 percent to 1.0 percent is normal; more than 1.2 percent may indicate a problem.
- Warning: Growing delinquency may mean charge-offs are not being done in a timely way.

Loans should be charged off when the likelihood that the loan will be paid off becomes remote. Loans that are 120 days delinquent are typically charged off.

**Net expense-to-assets ratio:** a primary measure of operating efficiency. How much you are spending to keep the credit union running divided by the credit union's assets.

- Monthly operating expenses, less fee (other) income, divided by total assets (annualized).
- \$220,000 in net operating expenses \* 12 / \$100 million in assets = 2.6%.
- Generally a lower number is better.
- Less than 2 percent is very efficient; 2 to 4 percent is moderately efficient; more than 5 percent may not be very efficient.
- Lots of branches and staff will make this number get big (worse).

**Efficiency ratio:** another primary measure of operating efficiency. Efficiency ratio is related to the net expense-to-assets ratio but focuses on the net profitability of the credit union.

- $(\text{Total Operating Expenses} - \text{Provision for Loan Loss}) / (\text{Total Gross Income} - \text{All Interest Expense})$
- $(\$350,000 - \$50,000) / \$700,000 = \$250,000$

## RESOURCES

CUES Pacesetter: Financial Performance Reporter can help demystify credit union financials. Log on to [cues.org/pacesetter/](http://cues.org/pacesetter/).

Read a post "Too Much Net Worth: The Elephant in the Kitchen" by John Dolan-Heitlinger on CUES Skybox at [cues.org/skybox](http://cues.org/skybox) by typing "elephant" into the search engine.

Get a grip on asset-liability management. Buy the CUES manual, *ALM Spelled Out*. Log on to [cues.org](http://cues.org), then select "Products." From the drop-down menu select "Finance & Operations." Finally, select "Finance & Operations Manuals."

Attend the CUES Director Development Seminar, Sept. 10-12, at the Hilton Branson Convention Center Hotel. For more information, log on to [cues.org](http://cues.org), then select "Conferences" from the drop-down menu.

= 67 percent.

- Generally a lower number is better.
- Less than 60 percent is very efficient, 60 to 75 percent is moderately efficient, more than 75 percent is inefficient.
- Low operating expenses, low interest expense and strong fee income will make this number smaller (better).

**Deposits-per-member ratio:** measures how much your members save with you.

- Total deposits (shares) divided by the number of members.
- \$92 million in deposits/9,000 members = \$10,222/member.
- Generally a higher number is better.
- \$4,000 or less is low, \$4,000 to \$7,000 is normal, more than \$7,000 is high.
- The amount of deposits is affected by the employment and age of your members.

**Loans-per-member ratio:** measures how much your members borrow.

- Total loans divided by number of members.
- \$90 million in loans/9,000 members = \$10,000/member.
- Generally a higher number is better.
- \$3,000 or less is low, \$3,000 to 6,000 is normal, more than \$6,000 is high.
- The amount of loans is affected by the employment and age of your members.

**Loan-to-share (deposit) ratio:** measures how you balance serving the needs of your borrowing and saving members.

- Total loans divided by total deposits (shares).
- \$90 million in loans/\$92 million in deposits = 98 percent loaned out.
- Generally a higher number is better unless you exceed 100 percent by too much and need more liquidity.
- Less than 70 percent is low, 70-95 percent is normal,

- more than 95 percent is high.
- This ratio is affected by the age of your membership and what services you offer.
- Look at the trend in this ratio over time.

Credit unions with an older membership generally have an easier time attracting deposits and a harder time attracting loans. Credit unions with a younger membership generally have a harder time attracting deposits and an easier time attracting loans.

**Checking accounts-to-members ratio:** measures how many of your members view your credit union as their primary place to do their banking.


- Total checking accounts/total members.
- 5,000 checking accounts/8,000 members = 63 percent penetration.
- Generally a higher number is better.
- Less than 40 percent is low, 40 to 60 percent is normal, more than 60 percent is high.
- Remember that checking accounts are labor- and technology-intensive.
- Look out for unused, low-balance accounts.

**Growth rates and trends** measure your progress.

- If your asset growth minus the current inflation

rate (3 percent) is 3 percent, the CU is standing still; 10 percent is fast; more than 20 percent is roaring.

- **Membership growth:** See asset growth numbers; make sure the members are active and not just \$5 share members with bad addresses.
- **One last number:** If you have increasing loans and an increasing delinquency rate of more than 1 percent you may have a problem brewing.

The ratios and trends covered in this article are a simplified set of criteria that all board directors should review each month. As with any credit union analysis, it is important to remember that your circumstances may require deviations from these norms. If the numbers you review in your board packets seem out of line, it is your responsibility to know why and to ask what is being done to bring the numbers into line. 

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